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Contracts Bulletin # 102 – All Breaches Are Not Created Equal –Understanding Breach and Default

No subcontractor wants to dwell on the consequences of an unfulfilled contract. However, in tough economic times, a subcontractor's performance is subject to heightened scrutiny as general contractors seek to preserve their tightening margins. Understanding the concepts of breach and default can help avoid unnecessary contractual liabilities.

In construction contracts, the distinction between a contractual "breach" and a contractual "default" is an extremely important one. In many industries, breach and default are synonymous, but the surety industry gives a special meaning to default that every bonded subcontractor should understand. Furthermore, all contracts make an important distinction between "breach" and "material breach."

These terms are all important to understand because of the consequences that flow from them: (1) a breach usually entitles the nonbreaching party to damages; (2) a material breach permits, but does not require, the nonbreaching party to terminate the contract and seek damages; and (3) a default is a material breach causing contract termination which may trigger the surety's performance bond.

When is a Breach Material?

To begin, it is necessary to understand the difference between a minor or technical breach of contract and a material breach of contract. A minor breach of contract is simply a violation of a provision in the contract. This includes any failure to strictly comply with the terms of the contract. For example, if a contract required a subcontractor to begin work at 8:00 AM, and the subcontractor did not begin work until 8:01 AM, that is a minor breach of contract. However, a court is not likely to award a contractor damages for such a minor breach.

Determining when a minor breach occurs is fairly simple; the hard part is determining when a breach becomes material. Whether a breach is material varies depending on the specific situation, considering such things as whether the injured party will be deprived of the benefits it reasonably expected from the contract, the extent to which the injured party can be compensated for the breach, and whether the breaching party acted in good faith. Put another way, a material breach occurs where the broken promise was so important that the contract would not have been made had lack of performance been originally known.

To return to the example above, the obvious question is, "if the subcontractor promised to begin work at 8:00 AM, but 8:01 AM is not a material breach, what time is?" Like most legal questions, the answer is, "it depends." If time was not "of the essence," meaning that the time for performance was not an essential part of the bargain, it is possible that the failure to show up – even at all that day – may not amount to a material breach. This is especially true when the no–show contractor calls with assurances that it will perform its

obligations the next day.

In construction contracts, time is often regarded as one of the most contentious issues between the parties. See Contracts Bulletins #54 (The Endless Project) and #85 (Liquidated Damages' Clause for Delays – Friend or Foe).

Regardless, a delay in performance constitutes a material breach when, (1) the party causes a substantial delay in performance, (2) a contract term expressly forbids such delays, and (3) the delay causes actual damages.

A material breach is usually found where the subcontractor either is unable or unwilling to cure the nonconforming workmanship. In U.S. ex rel. Virginia Beach Mechanical Services, Inc. v. SAMCO Const. Co., 39 F.Supp.2d 661, 671 (E.D. Va. 1999), a subcontractor breached its contract by failing to provide and install a roof exhaust fan, an incremental heat pump, four or five plumbing fixtures, a roof curb that met contract specifications, louvers and sheet metal ducts, and some minor plumbing work. The court found that this breach only became material when the subcontractor failed to give "adequate assurances" of performance when it failed to respond to two letters from the general contractor. The general contractor had to spend almost $6,000 to finish the work, and the contract was only for $10,000, but the court noted that "percentages alone" should not be relied on to determine if a breach is minor or material.

The Consequences of a Material Breach

This begs the next question, what happens when there is a material breach?

A material breach entirely discharges the injured party's obligation to perform, while a minor breach only allows the injured party to recover damages or a set–off against the breaching party. Put simply, a material breach generally permits the injured party to call the deal off and terminate the contract.

There are exceptions to the general rule which permit termination for material breach; the most important exception for construction purposes being if a contract's obligations are "divisible" or "severable." Under this exception, if the contract can be divided into separate parts, the non–breaching party must still perform its duties associated with the other parts of the contract so long as the breaching party has also performed its duties as to that other divisible portion of the contract.

For example, if a general contractor hires a subcontractor for two distinct projects, but both projects are put into one contract, it is possible that the subcontractor's material breach with regard to one project may not justify terminating the subcontractor with regard to the second project so long as the subcontractor is performing its obligations with regard to the second project.

The determination of whether a contract is divisible essentially turns on whether the parties reached their agreement with the understanding that the general contractor was exchanging all of its promises for all of the subcontractor's promises, or whether the general contractor exchanged one (or more) of its contractual promises for a specific promise from the subcontractor.

In other words, if you were to delete a promise or set of promises from the contract, would the parties have still made the bargain? In the separate project example, it is possible that the general contractor would have still contracted with the subcontractor for one project if the subcontractor was unable or unwilling to take on the second. However, if the general contractor was specifically looking for one subcontractor to do two projects, then the contract is probably not divisible and a material breach related to one contract may justify termination of the subcontractor for both projects.

In any event, there is an arguable presumption that when parties enter into a contract, each and every term and condition is in consideration of all the others. That is, the contract is presumed to not be "divisible" and can be wholly terminated if there is a material breach.

Material Breach vs. Default

You may think that a "breach" and a "default" are the same thing; and it is true that the terms "breach" and "default" are sometimes used interchangeably. However, the terms have very different meanings when it comes to construction surety contracts. See Generally Contracts Bulletins #32 (Bonding on Federal Projects – The Miller Act Provisions) and #46 (The Missing Bond).

There are usually three parties to construction surety contracts – a general contractor, a subcontractor, and a surety who guarantees the subcontractor's performance. The term "breach" refers to any violation of the contract between the general contractor and subcontractor, while a "default" is an event that triggers the surety's obligations under the contract. To constitute a default, generally there must be a (1) material breach or series of material breaches, (2) of such magnitude that the general contractor is justified in terminating the contract.

While there are no hard and fast rules that clarify the "magnitude" requirement, the amount of the general contractor's damages may be a good guidepost. If the subcontractor's breach is costing the general contractor thousands or (depending on the size of the contract) even perhaps several hundred thousand dollars, then it is probably justified in terminating the contract.

Almost all suretyship contracts also require the general contractor to give notice to the surety of the subcontractor's default. This is sometimes called a "declaration of default." Given the magnitude of the surety's obligations (e.g. taking over all of the subcontractor's obligations), and the surety's inability to interfere with the subcontractor's performance prior to a default, courts generally require that the declaration of default be made in terms that are clear, direct, and unequivocal; simply writing to the surety stating that the subcontractor's work has been delayed or is otherwise deficient will not suffice. Using an explicit statement like, "I am declaring XYZ Corp. in default under the terms of the performance bond," is advisable.

Once there has been a rightful declaration of default, the surety has the option of stepping into the shoes of the subcontractor and finishing the work itself, or simply paying the general contractor's damages. It is important to note that, unless the bond provides otherwise, it is the surety that gets to make the decision. Indeed, a general contractor's actions that deprive the surety of its ability to protect itself, usually by not allowing the surety to participate in the selection of the replacement subcontractor, voids the performance bond altogether. Some courts, instead of voiding the bond, only reduce the surety's liability to the extent the surety was unable to minimize its expenses through selecting a replacement contractor. Once again, the lesson here is to communicate fully and be reasonable.

Conclusion

The distinctions between breach, material breach, and default in construction contracts are important, and every general contractor and subcontractor should understand them. Minor breaches will happen, but material breaches will normally only occur where a minor breach is neglected or there is a communication breakdown. It is only after a material breach and contract termination following default that triggers the surety's performance bond. Understanding whether a material breach or a default has occurred means the difference between a mere business "problem" and a catastrophe.

(It is important to keep in mind that this Contracts Bulletin is only a general overview of the law in this area. Because laws in individual states may vary, it is recommended that you seek legal advice.)

SMACNA wants the Contracts Bulletin to serve our members. Your feedback or topic suggestions are welcomed by contacting Mike McCullion at 703–995–4027 or mmccullion@smacna.org.

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